8415

In the

United States Circuit Court of Appeals

For the Ninth Circuit

No. 8415

E. WAGNER & SON, INC., a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of Decision of the United States Board of Tax Appeals

Reply Brief of Petitioner

ELDER & HILL,
ANDREW G. ELDER,
CYRIL D. HILL,
Attorneys for Petitioner.

Dexter Horton Building,
Seattle, Washington.

MAIN 2279
94 Spring Street
SEATTLE, WN.

INDEX

CITATIONS

In the

United States Circuit Court of Appeals

For the Ninth Circuit

No. 8415

E. WAGNER & SON, INC., a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of Decision of the United States Board of Tax Appeals

Reply Brief of Petitioner

INTRODUCTION

In his answering brief, respondent has discussed the questions involved in the same order as in petitioner's opening brief. We will reply in the same order. There is no substantial evidence to sustain the Board in refusing to allow the (A) compensation claimed for the officers and the (B) interest as cal-

culated. Furthermore, the (C) computation of tax in petitioner's brief is correct.

A. COMPENSATION OF OFFICERS

Respondent contends there is substantial evidence to support the findings of the Board, and proceeds to set forth the evidence upon which he relies, commencing on page 10 of his brief.

1. He contends that the 1929 salaries are excessive when compared with prior years. He merely refers to prior salaries of $2000 to $4000 per year and states that taxpayer failed to produce evidence to support the increase other than the opinions of the two Wagners.

He fails to realize that the amount of salaries paid during former years is no measure of the reasonableness of the salaries during those years nor for the year in question. He cites *A. David Co. v. Grissom*, 64 F. (2d) 279, 12 A. F. T. R. 395, wherein both he, the Board, and the Court had approved an immediate salary increase from $150 per month to $7000 per year.

He fails to mention:

a. The uncontradicted evidence that the salaries for prior years were inadequate (R. 51,

56). *Jones v. Helvering*, 71 F. (2d) 214, 14 A. F. T. R. 262.

b. The uncontradicted evidence that the failure to receive adequate salaries in prior years was considered in fixing compensation for 1929 (R. 42, work "justified" more; R. 46, "reasonable salary for 1929"; R. 52, "laboring man's salary").

2. He next contends (Br. 12) that taxpayer could not be considered a large company in 1929. Neither is this a measure of the reasonableness of salaries. He refers to the $15,000 to $20,000 valuation of the plant equipment in 1924, the lack of experience and capital, the small operations "at first", the value of improvements based on what money could be borrowed. He may say that taxpayer was a comparatively small company in 1929, but only in the same sense that he should say that a $13,000 salary was a comparatively small salary in 1929.

He cites *H. L. Trimyer & Co. v. Noel*, 28 F. (2d) 781, 7 A. F. T. R. 8221, wherein a salary of $15,000 and total salaries of $23,850 were held reasonable in a corporation with invested capital of only $15,000 and a gross business of $170,503.39.

He admits 1929 was a "big year" for taxpayer. But he fails to mention:

a. The value of the plant, property and equipment of $110,520.78 to $145,373.00 in 1929 (R. 86) and a gross business exceeding $220,000.00 (R. 36).

b. The capital employed in 1929 of $105,-104.45 to $117,774.50 (R. 88).

c. That although the *bank* credit for payrolls was limited to $15,000 (R. 44, 60) petitioner had total credits of more than $60,000 at the close of 1929 (R. 87).

d. The long experience of E. Wagner in the saw mill business beginning in 1888 in Castle Rock (R. 59) and continuing to this saw mill (R. 42, 57).

3. He next contends (Br. 13) that the difficulties involved in financing the business are evidence that the corporation could not afford to pay these salaries. In other words, even though the business made a fair profit in 1929 (R. 65), the excessive struggle involved in financing the business should be without reward, because that struggle evidences inability to pay adequate salaries.

He fails to consider:

a. That the Wagners sacrificed and dug up every cent they could for the business in order

to keep it going (R. 56). They made advances and left portions of their salaries with the company. They had everything at stake. The company was "under financed" (R. 44). They had to make a go of the business. It was an extra hazardous undertaking. Banks were cautious. "Loans to saw mills were a poor risk" (R. 44). Credit was limited. The Wagners had to actually personally endorse the company's notes before the company could get any money in 1929 (R. 44), even the limited amounts necessary for payrolls. This was to that extent a waiver of the advantage of limited liability in corporate operation. This *added responsibility* should be considered in determining reasonable salaries.

b. That seasonal operations required available cash, and regardless of the age of a business, difficulty along this line is not unusual. It is more to the credit of these men that they managed to keep the business going and successfully making money in spite of the hardships.

c. The limit of "$15,000 from outside sources" (Br. 13) was "the maximum bank credit for payrolls" (R. 44, 60), not the maximum amount they had borrowed (R. 87).

d. The ability to pay salaries is not based upon freedom from financial struggles.

e. As was the case in former years, the failure to withdraw salaries in cash is no "indication that the amounts agreed upon for 1929 were larger than the petitioner could afford to pay" (Br. 13). Leaving money with the company evidences extra added burden and effort, and should be considered.

4. He next contends (Br. 13) that the nature of the duties of Otto Wagner had not "changed materially in that year except for longer hours" (R. 44). This is not supported by the evidence. We must insist that the work and salaries of former years is no measure of the reasonableness of salaries for those years nor for the year in question. He does not attempt to establish the reasonableness of the salaries of former years. Although he mentioned the longer hours in 1929 and the fact that the Board of Tax Appeals was satisfied that his (Commissioner's) allowance was not adequate, he fails to mention the evidence serving as a measure by which the Board fixed the salary of Otto Wagner for 1929.

5. He next contends (Br. 15) that Mr. E. Wagner "was 74 years old in 1929." This contention, based on error of fact, raises an unfair inference; a fur-

ther one that the value of an officer's services would automatically be impaired if he were over 70 years of age. However, Mr. E. Wagner was only 69 years of age in 1929 and "the state of his heath was firm" (R. 51). He was 74 at the time of the trial in this proceeding in 1934 (R. 56, 2).

6. He next contends (Br. 15, 16) that the duties of Mr. E. Wagner were not "heavier than they were in prior years." He seems to belittle the extra subdivision work, construction of houses, duty at the manufacturing plant, timber scouting, ability to earn "more than $13,000 in other lines of work" and leaving for rest early in October. These references, as well as the other evidence referred to in the Record indicate "heavier" duties. In addition:

a. Mr. E. Wagner was on the job nine months of the year in question. The heavy duties broke his health.

b. Although the superintendent did work longer in the fall of 1929 and did put in more time in that sense, Mr. E. Wagner worked all day and far into the night (R. 58) while the superintendent only put in one shift at the mill and this only for the mill season. He put in about half the time the Wagners were putting in (R.

55). The respondent fails to recognize that it is not the number of hours that is controlling; for this would completely ignore the fact that the value of Wagner's services was measured also by his experience, business and trade contacts, financial liability, ripened executive judgment, and the burden of the responsibility for success of this enterprise. That this is true is fully borne out by the fact that petitioner made substantial profit during the year under review.

c. The Board held the salary allowed by the Commissioner was inadequate. It was satisfied there were heavy duties in 1929.

7. He next contends (Br. 16, 17) that the 1929 salaries were a distribution of profits in disguise. The Board made no such finding. He refers to the fixing of increased salaries in June, 1929, when they "realized they were going to have a big year." The officers fully recognized that they had *earned*, and for the year 1929 would earn much more substantial compensation than was then being or had theretofore ever been paid them. The volume of business and the amount of the probable earnings of the petitioner would then for the first time in its history permit the payment of reasonable compensation.

While the respondent seeks to infer that the increased compensation was improper merely because the officers realized that the earnings of the company would be adequate to do so. This fact in no way minimizes or negatives the propriety of the action taken; for it would indeed be a challenge to their sound business judgment if they had approved of more substantial compensation without knowledge or reasonable expectation that the company would be *able to pay* the compensation authorized. The work and responsibilities determine the reasonableness of the salaries.

Central Wisconsin Creamery Co., 15 B. T. A. 396.

William S. Gray & Co. v. U. S., 68 Ct. Cl. 480, 35 F. (2d) 968, 8 A. F. T. R. 9798.

Francesconi & Co., 10 B. T. A. 658.

Livingston & Co. v. U. S., 67 Ct. Cl. 626, 7 A. F. T. R. 9108.

These salaries were reported in personal income tax returns. The respondent does not complain of this nor of the income taxes paid on them.

In summarizing, the Commissioner relies, for his substantial evidence, upon these assertions:

(1) The small salaries for 5 years prior to 1929. (Admitted).

(2) Petitioner was a small company in 1929. (Comparative statement not borne out by evidence.)

(3) Petitioner had financial difficulties in 1929. (Admitted.)

(4) "Longer hours" was the only material change in duties of Otto Wagner. (Wholly unsupported by the evidence.)

(5) Mr. E. Wagner was an old man. (He was 69 and capable.)

(6) The duties of Mr. E. Wagner were not heavier than in former years. (Also wholly unsupported by the evidence.)

(7) Salaries were profits in disguise. (Unwarranted inference from any of the evidence.)

He now suggests that the findings of the Board are partially unsupported by the evidence (Br. 3 n 1.)

May we again quote from the Board member who conducted the hearing, the Honorable Stephen J. McMahon, who in his dissenting opinion, concurred in by the Honorable J. Russell Leech, states:

> "The record fails to disclose evidence to support a finding of fact or holding that a reasonable allowance as compensation for services rendered by the Wagners for the year 1929 is less than $13,000 each. The witnesses for petitioner

were intelligent, candid and in all respects credible; their testimony was not impeached; and no countervailing evidence was offered by respondent." (R. 20.)

B. INTEREST

The argument of respondent concerning the allowance of interest is based upon the assumptions that there was no obligation to pay interest and that there is no evidence of the correct amount of interest.

1. He first relates (Br. 18, 19) that the item in dispute is $2750 "interest accrued on loans from officers." The Court is not bound by statements in the opinion.

Commissioner v. Bonwit, 87 F. (2d) 764, 766. The amount of this item was corrected in evidence to $1743.73 (at 6%, and $2906.22 at 10%) (R. 38, 39, 40, Exhibits 6 and 7, R. 101, 102), and is properly referred to in assignments of error (5), (6), (14) and (15). Respondent disregards these corrections (Br. 18 n 2) for the reason the Board made no findings concerning them. That is why we are appealing this case. Both the respondent and the Board disregarded the evidence (R. 38, 39, 40, 101, 102). The attorney for respondent agreed that Exhibits 6 and 7 (R. 101, 102) showed the correct computation of interest at six per cent and ten per

cent on the advances and undrawn salaries (R. 39, 40). There is no question but that this is the item in dispute.

2. He next contends (Br. 19) there was no obligation to pay interest. However, he relates that according to the books interest was actually allowed. Then, it must have been agreeable or else it would not have appeared there. He then relates (Br. 20) that interest is not allowable "unless it is the subject of an express agreement or is specifically allowed by statute or by some well established business custom." The statutes and cases of the State of Washington (R. 24) allow interest at 6 per cent in case of *forbearance* as here, and on loans where no other rate is agreed to.

Sec. 7299, Rem. Rev. Stat. of Wash. (R. 24).

Benner v. Billings, 107 Wash. 1, 181 Pac. 19.

Dornberg v. Black Carbon Coal Co., 93 Wash. 682, 161 Pac. 845.

The advances are definite loans and such interest is also allowable.

He cites (Br. 21) and relies upon the case of *Miller Safe Co.*, 12 B. T. A. 1388, contending no interest is payabe on advances without an agreement. The Board and Commissioner there allowed 6% interest in the sum of $2,137.45 for the current taxable period

on all advances, although, according to the stipulated facts, "when the foregoing advances were made to petitioner it was considered by both the borrower and lender that they were not formal loans, and that they would be repaid promptly out of expected profits, which, however, did not materialize. Neither party intended and there was no agreement for payment of interest on these advances, and it was only due to the fact that the petitioner made a profit in 1919 that this interest was paid." Not only was no statute cited as authority for the calculation of interest by the lenders, but the findings in the case disclose that the petitioner kept its books on the accrual basis and that the additional interest claimed as a deduction represented accruals thereof for *nine previous years*. The interest accrued for the current period under review had been allowed by the respondent. It is thus seen that the case cited by respondnt not only is no authority for the disallowance of the deduction of interest sought by the petitioner in the instant case, but in fact inferentially supports its contention.

The cited *Dugan* case (Br. 21) is one of an unliquidated balance on a drawing account not due. Interest is allowed to partners on advances and undrawn salaries. In *Keiley v. Turner*, (Md.) 31 Atl. 700, 703, the Court states:

"The record shows us that Keiley allowed large portions of his salary to remain in the hands of the firm. These sums were used for its benefit and were contributions on his part to its capital. He ought to be paid interest on these amounts; not on the ground that payment was withheld by the firm, but for the reason that he furnished money which was used in the transaction of its business. Payments of salary were due monthly, and from the time they became due, interest is properly chargeable for his benefit."

Matthews v. Adams (Md.), 35 Atl. 60.

Coldren v. Clark (Ia.), 61 N. W. 1045.

3. He next contends (Br. 22) that the salaries and bonuses were not payable prior to the end of 1929. "The books, as closed, show that the salaries were payable monthy, and the bonuses were payable on October 1, 1929, and respondent has made no contention to the contrary. In fact, as stated, he in effect agreed that the exhibits were correct, and such exhibits treat the compensation as payable prior to the close of the year. Furthermore, in the absence of any agreement to the contrary, it is the universal custom to treat salaries as accruing monthly even though they are fixed at a yearly rate. Otherwise, people, dependent upon their salaries would be unable to meet living expenses. In neither the case of the salary nor the case of the bonus is interest claimed before the date on which the payment was duly au-

thorized and respondent has raised no question as to this. The bonuses were payable forthwith; and being on the accrual basis, they were accruable when authorized, and the salaries were accruable at the end of each month. There is nothing in the record to require or justify a failure or refusal to accept these exhibits for the purpose for which they were offered and received." (R. 23.) Opinion of Honorable Stephen J. McMahon. (R. 101, 102, Exhibits 6 and 7.)

The Commissioner's contention does not apply to any loans or advances left with the company as of January 1, 1929.

4. He next contends (Br. 23-26) there is no showing as to the correct amount of interest. He disregards Exhibits 6 and 7 (R. 101, 102) admitted for that very purpose, agreeable to respondent's attorney (R. 38, 39, 40). The correct amount is $1,743.73 (at 6% and $2,906.02 at 10%).

The respondent contends (B. 24) that Mr. E. Wagner drew $5000 out of his 1929 salary in October. He cites pages 60 and 61 of the Record. It does not sustain him. It does not state that $5000 was drawn from 1929 salary. At most, the Record is ambiguous on this point. The Board in its findings makes this statement: "E. Wagner and Otto H.

Wagner did not withdraw any of the salary or bonus authorized by the petitioner for the year 1929." (R. 14.) Mr. E. Wagner regarded his balances with the company as one account. He bought his steamship ticket in September. Counsel tries to infer the ticket cost $5000. The court could take judicial notice that a steamship ticket to New Zealand would cost but a small fraction of that sum. However, the other evidence clears up this point. He "drew a thousand dollars at a time" (R. 60). He drew "approximately $5000" (R. 60). Exhibit 6 (R. 101) shows he had drawn approximately $5000 from March 1, 1929, to November 1, 1929, $5,179.22 to be exact. He stated he still had a balance due of $10,000 (R. 61). He was hard of hearing at the time of the trial (R. 60). Furthermore, he was testifying from memory. Five years had passed. The exhibits were agreed to be the exact figures (R. 38, 39, 40). They show the amount on which interest was due, dates payable, balances after withdrawals, together with dates (R. 101, 102).

He next contends (Br. 25) that the petition for review states that he allowed interest on salary and advances of prior years during 1929. On the following page of his brief (Br. 26) he interprets the petition for review as stating that "interest for prior

years was allowed as a deduction." We must not be confused in this. In the first place the petition for review is not evidence. The admitted evidence is clear as to the issues and the facts. May we clarify this point for respondent. Petitioner made deductions in its income tax return for 1929 covering the 1929 interest on balances of advances, loans, salaries and bonuses due officers as indicated in the evidence. It also made deductions in its income tax return for 1929 covering the 1929 interest on loans to outsiders made prior to and during 1929. Petitioner had deducted interest in prior tax returns for prior years which respondent had allowed. Respondent allowed interest during this year on loans to outsiders made prior to 1929. But respondent disallowed interest during 1929 on loans, advances, salaries and bonuses left by the officers with petitioner during 1929. Interest for 1929 to outsiders was allowed in the sum of $2,009.53 (R. 66, 83, 98, 100).

Respondent refers (Br. 26) to this item of $2,009.53 as if there were some mystery surrounding it. This item was not in issue inasmuch as it was interest on loans and obligations to *outsiders*. Respondent contends these items did not exceed $15,000 (Br. 26) but we have shown them to be from $22,707.48 to $60,558.26 (R. 87). The $15,000 refer-

ences cited by respondent are "bank credit for payrolls operation during 1929 was $15,000" (R. 44), "the rate of interest" in the vicinity of Seattle "was ten per cent" (R. 49), "our bank credits would only allow us $15,000" (R. 60). The $15,000 item was the limit of bank loans.

C. COMPUTATION OF TAX

Counsel for the respondent point (Br. 27) with somewhat light disdain to an asserted computation by the petitioner (p. 21 of its brief) of the tax "as it contends it should be if the Board's decision is reversed" (Br. 27), and ventures the suggestion that such a computation has no proper places in briefs, and calls "attention to the fact that the petitioner is in error in figuring the tax at 11 per cent since the rate given in the 1928 Act is 12 per cent." (Br. 27.)

But upon reference to page 21 of the petitioner's brief it will be noted that the statement merely sets forth, for convenience of reference, the computation of the tax as submitted by the respondent under Rule 50 (R. 17, 28) on which the final order was based.

The section of the Revenue Act of 1928 cited by respondent's counsel is correctly set forth in the Appendix to his brief (Br. 28), but obviously overlook-

ing the fact that the rate of tax applying to the taxable year 1929 is 11 per cent, as used in the computation. (U. S. C. Sup. III, title 26, Sec. 2013, 46 Stat. at L. 47, Public Resolution No. 23, 71st Congress, approved December 16, 1929, and effective January 1st of that year.)

CONCLUSION

We submit that respondent has been unable to discover substantial evidence in the record to support his contentions. We respectfully contend there is no "evidence to support a finding of fact or holding that a reasonable allowance as compensation for services rendered by the Wagners for the year 1929 is less than $13,000 each." Furthermore, the record is clear and uncontradicted that interest is due on the loans, advances and salary balances. It should be allowed. Finally, the tax computations by petitioner are correct.

Respectfully submitted,

ELDER & HILL,
ANDREW G. ELDER,
CYRIL D. HILL,

Attorneys for Petitioner.

Dexter Horton Building,
Seattle, Washington.